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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.,
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

BRIEF FOR CHEVRON CORPORATION, THE COCA-COLA COMPANY, E.I. DuPONT DE NEMOURS AND CO., FORD MOTOR COMPANY, GENERAL MOTORS CORPORATION, INTERNATIONAL BUSINESS MACHINES CORPORATION, MOBIL OIL CORPORATION, NCR CORPORATION, AND W.R. GRACE & CO. AS AMICI CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF THE AMICI CURIAE

The amici curiae are multinational corporations, each of whom has subsidiaries and/or affiliated corporations that do business abroad and are incorpo-

rated under the laws of foreign countries.[1] Each receives dividends from its foreign subsidiaries. Each also conducts business in, and is subject to income taxation by, Iowa and the several other states that compute a corporation's taxable income by including dividends from foreign subsidiaries while excluding dividends from U.S. subsidiaries.

Discriminatory state taxation of foreign-source dividends places amici at a material competitive disadvantage, requiring them to bear a higher effective tax rate than those of their competitors that operate exclusively within the United States. Amici accordingly have a strong interest in vindicating the anti-discrimination principle of the Foreign Commerce Clause, not only to eliminate discriminatory state tax schemes that currently penalize foreign commercial operations, but also to forestall the proliferation of such schemes that would almost certainly be triggered if this Court were to uphold the Iowa system.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

SUMMARY OF ARGUMENT

The Iowa Supreme Court reached the wrong conclusion because it asked the wrong question. The test for impermissible discrimination under the Foreign Commerce Clause is not whether Iowa provides a commercial advantage to in-state commerce at the expense of out-of-state commerce, but whether it favors U.S. commerce over foreign commerce. The Interstate Commerce Clause, by its negative implications, prohibits commercial localism; the Foreign

[1] For convenience, we use "subsidiary" to refer to any wholly owned or partially owned corporation, regardless of the percentage of ownership.

Commerce Clause, in contrast, forbids commercial *nationalism*.

That fundamental prohibition is embodied not only in this Court's Foreign Commerce Clause decisions but also in the history and animating purposes of the clause itself. The Articles of Confederation had assigned expressly to the states the power to regulate foreign commerce. It became apparent, however, that a single state's discriminatory measure, though adopted to further a legitimate local objective, had the balkanizing effect of inflaming the resentment of other states and subjecting the entire nation to the risk of foreign reprisals. The states came to recognize that each could go its own way only at the expense of the others and that their collective well-being as participants in the international commercial community required a mutual surrender of their foreign commerce powers to the central government. They accordingly agreed in the new Constitution to allocate to Congress the authority to regulate commerce with foreign nations.

That cession of authority does not foreclose all state taxation of foreign commerce. Like interstate commerce, foreign commerce may be made to pay its way. Among other limitations imposed by the Foreign Commerce Clause, however, state taxation of foreign commerce, no less than state regulation of interstate commerce, must be even-handed and non-discriminatory. *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-51 (1979). To hold, as the Iowa court did, that the states may impose discriminatory burdens on foreign commerce—just as they were empowered to do under the Articles of Confederation—would nullify a core purpose of the Foreign Commerce Clause by allowing an individual state to ex-

pose the entire nation to the risk of international retaliation.

Iowa requires multinational companies to bear additional tax burdens solely because their foreign subsidiaries do business outside the United States. By disproportionately encumbering dividend income derived from foreign activities, the state's tax scheme inherently favors U.S. over foreign operations and necessarily skews the investment decisions of multinational businesses by adding discriminatory tax burdens as an additional consideration. Congress alone has the authority to enact such domestic preference legislation; it is forbidden to the states.

ARGUMENT

IOWA'S DISCRIMINATORY TAXATION OF FOREIGN-SOURCE DIVIDENDS VIOLATES THE FOREIGN COMMERCE CLAUSE

The dispositive question in this case is whether the Foreign Commerce Clause prohibits state taxation that facially discriminates against foreign commercial activity in favor of U.S. commercial activity. If it does, the Iowa tax is invalid.

It is discernible from the face of the Iowa statute that it treats foreign-source dividends less favorably than domestic-source dividends. In the words of the Iowa Supreme Court, the state "allows a deduction for dividends received from domestic corporations, but it does not allow a deduction or tax credit for those received from foreign subsidiaries." Pet. App. 2a. As this Court has recognized, the taxation of dividends effectively burdens "the underlying activity" that gives rise to the income out of which the dividends are paid. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 440 (1980). Iowa's admittedly disadvantageous treatment of foreign-source dividends therefore operates as a discriminatory burden on the underlying foreign commercial activity itself in favor of domestic commercial activity. As a leading economist has observed, "the inclusion of foreign-source dividends in apportionable income . . . creates discrimination against the economic activities of domestic multinationals." C. McLure, Jr., *Economic Perspectives on State Taxation of Multijurisdictional Corporations* 179 (1986).

The Iowa Supreme Court did not dispute that conclusion. In its view, however, discrimination against foreign commercial activity does not offend the Foreign Commerce Clause unless it benefits exclusively *in-state* commercial activity or businesses. "[W]e hold that Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." Pet. App. 7a. That holding is fundamentally wrong as a matter of logic, precedent, and constitutional structure.

1. In the first place, the Iowa court failed to recognize that the Interstate Commerce Clause and the Foreign Commerce Clause require different inquiries. The Interstate Commerce Clause protects the national market from state-enacted local protectionism; the focus is therefore on in-state benefits and out-of-state harms. The Foreign Commerce Clause, by contrast, protects the *global* market from state-enacted *domestic* protectionism; the proper focus is therefore on U.S. benefits and foreign harms. The Iowa court mistakenly viewed this foreign commerce case through a distorted interstate commerce lens.

But even if, as the Iowa court held, discrimination against foreign commerce were impermissible only if it

benefited in-state business, the Iowa tax would satisfy that requirement. Under the state's scheme, the disfavored class is composed of foreign commercial activities conducted by foreign subsidiary corporations; the favored class is composed of domestic commercial activities conducted by U.S. subsidiary corporations. The favored class therefore *includes* commercial activities conducted in Iowa and by Iowa corporations: the state allows a deduction for dividends received from an Iowa subsidiary or from a domestic subsidiary whose income is derived from Iowa business activity. The state's tax thus necessarily discriminates not only against foreign commerce but also in favor of Iowa commerce.

According to the Iowa court's analysis, however, even that is not enough. In its view, because the favored class embraces U.S. commerce in general rather than Iowa commerce exclusively, the discrimination is not cognizable under the Foreign Commerce Clause. Under that interpretation, the Foreign Commerce Clause would come into play only if the favored class were composed *solely* of in-state commerce or in-state businesses. In that event, however, the disfavored class would be composed of out-of-state commerce or businesses, and the measure would therefore constitute a prohibited discrimination against *interstate* commerce. If the Iowa court's approach were correct, therefore, the antidiscrimination principle of the Foreign Commerce Clause would become superfluous; it would add nothing to the prohibition of the Interstate Commerce Clause.

The Iowa Supreme Court went astray because of its misapprehension of this Court's interstate commerce decisions. This Court has said that the Commerce Clause prohibits discriminatory state taxes

that disproportionately burden interstate commerce and provide a "commercial advantage to local business." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268 (1984). But nothing in its decision implies that local business must be the *exclusive* beneficiary of the discrimination; it is enough that local business is *among* the beneficiaries.

That is the clear inference from *New Energy Co. v. Limbach*, 486 U.S. 269 (1988). The Court there invalidated, under the Interstate Commerce Clause, an Ohio tax credit for sales of ethanol that was available only if the ethanol was produced in Ohio or in another state providing reciprocal tax advantages to Ohio-produced ethanol. There was no showing made or required that the discrimination favored only Ohio ethanol producers; on the contrary, the statute plainly extended the discriminatory tax benefit to producers in other states with reciprocity.

That principle is fully applicable to the taxation of dividends. For example, the Interstate Commerce Clause would not permit Iowa to tax dividends received from all subsidiaries except those incorporated in states west of the Mississippi. The law would impermissibly discriminate against some out-of-state businesses in favor of Iowa businesses. It would not be saved merely because non-Iowa businesses west of the Mississippi would also benefit. By the same token, Iowa's discrimination against foreign-source dividends is not saved merely because non-Iowa domestic-source dividends also benefit from the exclusion.

Moreover, this Court's Foreign Commerce Clause decisions make clear that discrimination against foreign commerce in favor of domestic commerce is forbidden without regard to whether in-state commerce

is the exclusive beneficiary. Thus, in *Cook v. Pennsylvania*, 97 U.S. 566 (1878), the Court struck down as impermissible discrimination against foreign commerce a Pennsylvania auction tax that applied only to "foreign goods" and exempted goods of "American growth or manufacture." *Id.* at 570. It was of no consequence that the favored class embraced more than just goods of *Pennsylvania* growth or manufacture.

More recently, but to the same effect, the Court invalidated a Florida inspection fee that worked a "calculated discrimination against foreign commerce." *Hale v. Bimco Trading, Inc.*, 306 U.S. 375, 380 (1939). The statute levied an inspection fee on " 'cement imported or brought into the State of Florida from any foreign Country ' "; it assessed no such fee on U.S. made cement. *Id.* at 379. As in *Cook*, the discrimination was prohibted even though it provided a commercial advantage to all domestically produced cement, not merely Florida cement.

The lesson is clear: where a tax classification facially discriminates against foreign commerce on account of its foreign character, that is sufficient to invalidate it without regard to whether the discrimination operates to benefit all U.S. commerce or only in-state commerce.

2. That conclusion is firmly grounded in the history and purpose of the Foreign Commerce Clause. The Articles of Confederation had restricted the power of the national government and had given the states plenary authority over foreign commerce. The national government could take no action that "restrained" the states from "imposing such imposts and duties on foreigners, as their own people [were]

subjected to, or from prohibiting the exportation or importation of any species of goods or commodities whatsoever." Articles of Confederation of 1777, art. IX, § 1.

In the exercise of that power, the states enacted "a variety of commercial regulations." *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 226 (1824) (Johnson, J., concurring). Some states adopted discriminatory measures to "coerce a relaxation" of foreign "monopol[ies]" over trade and navigation, as well as "to supply their respective treasuries by imposts." 3 M. Farrand, *The Records of the Federal Convention of 1787* 547 (rev. ed. 1966) (Madison). Massachusetts, for instance, passed "prohibitory acts" for "the express 'encouragement of the agriculture and manufactures in our own country.' " *United States v. The William*, 28 F. Cas. 614, 623 (D. Mass. 1808) (No. 16,700).

The Constitution marked a dramatic reversal of roles. "One of the major defects of the Articles of Confederation, and a compelling reason for the calling of the Constitutional Convention of 1787, was the fact that the Articles essentially left the individual States free to burden commerce both among themselves and with foreign countries very much as they pleased." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 283 (1976). The Constitution was "framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 523 (1935).

In place of the states' "partial and separate reguations," 1 J. Elliot, *Debates on the Federal Constitu-*

tion 114 (2d ed. 1888), the Convention of 1787 sought a "vigorous national government . . . directed to a common interest." *The Federalist No. 11*, at 69 (Hamilton) (J. Cooke ed., 1961). The Framers believed that, "[i]f we are to be one nation in any respect, it clearly ought to be in respect to other nations." *The Federalist No. 42*, at 279 (Madison) (J. Cooke ed., 1961). That vision manifested itself, among other provisions, in the Foreign Commerce Clause, which reassigned from the states to Congress the power "to regulate Commerce with foreign nations." U.S. Const. art. I, § 8, cl. 3.

The Foreign Commerce Clause constituted "a voluntary surrender" of the states' "power to encourage domestic manufactures by the regulations of commerce." J. Story, *Commentaries on the Constitution* § 529 (R. Rotunda & J. Nowak eds., 1987). The Framers recognized that an individual state, acting pursuant to its own commercial interests, might adopt a discriminatory regulation that would invite foreign reprisals against the entire nation. "Whatever regulations foreign commerce should be subjected to in the ports of the Union, the general government would be held responsible for them." *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) at 228-29 (Johnson, J., concurring). Thus, foreign commercial retaliation, even if provoked by a single state's tax measure, "of necessity would be directed at American [interests] . . . in general, not just that of the taxing State, so that the Nation as a whole would suffer." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. at 450.

The Framers sought to ensure that measures bearing an inherent risk of international commercial retaliation would lie within the sole discretion of the national government, acting in the collective self-

interest of all the states, rather than within the power of each individual state acting by its own lights. "If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung v. Freeman*, 92 U.S. 275, 280 (1876).

That central objective illuminates the question here. Even-handed state regulation that allows foreign and domestic commerce to compete on a level playing field is not likely to provoke foreign reprisals, and does not impair the federal government's exclusive regulation of foreign commerce, because it imposes on foreign commerce no special burdens on account of its foreign character. *See Michelin Tire Corp. v. Wages*, 423 U.S. at 286. But discriminatory state regulation that treats foreign commerce less favorably than domestic commerce carries with it an intrinsic risk of international retaliation. The burden of any such reprisal would be borne not by the offending state alone, but by all the states. The Foreign Commerce Clause was intended to prevent just this sort of unilateral state action that inherently jeopardizes the commercial interests of the entire Union.

3. The constitutional defect in Iowa's taxing scheme is not merely a technical one; it has substantial practical implications that are demonstrably unfair to companies engaged in foreign commerce. The Iowa system guarantees disparate tax treatment for two corporate taxpayers that are identical in every respect except that one receives dividends from a domestic subsidiary and the second receives dividends from a foreign subsidiary. Under the Iowa scheme, the foreign-source dividends will be included in the Iowa income base, and the domestic dividends will be

excluded because of the intercorporate dividend deduction provided under federal law. That difference in treatment discriminates against foreign commerce because it directly results in a higher Iowa corporate income tax on the company with foreign subsidiary income.

A simple example illustrates the extent to which Iowa's approach discriminates against foreign commerce. If we assume two corporations whose operations are indistinguishable, except that one receives dividends from a domestic subsidiary and one from a foreign subsidiary, plain calculation shows that the disparity in Iowa tax is significant. Thus, we assume that the two parents and the two subsidiaries all have the same pre-dividend taxable income ($1 million), that the U.S. and foreign governments each impose the same 20% corporate tax rate on the respective subs, and that both subs distribute all of their post-tax income as dividends. We further assume that each parent does business equally across the United States and therefore that 2% of its income is apportioned to Iowa.

The calculation in the case of the parent with a domestic subsidiary is straightforward. The Iowa tax base will exclude the dividend received from the domestic subsidiary, so that the Iowa tax base is an apportioned share of the parent's own income, $20,000 (2% of $1 million). Assuming a 12% Iowa tax rate, that yields Iowa income tax on the parent of $2,400.

In the case of the company with a foreign subsidiary, the pre-apportionment Iowa tax base includes the parent's own income ($1 million) plus the dividend received from the subsidiary ($800,000), for a total of $1.8 million. The Iowa tax on its portion of

that income will be $4,320 (12% tax on 2% of $1.8 million), almost double the Iowa tax on the parent that operates a domestic subsidiary.[2]

4. There is no sensible justification for Iowa's discrimination. The Iowa Supreme Court sought to justify the state's approach by stressing the convenience of relying on federal regulation and using the federal tax form. But Iowa is selective in the extent to which it adopts the federal system. Iowa is content to adopt the aspect of the federal system that provides a deduction for dividends received from a domestic subsidiary, while including in income dividends received from a foreign subsidiary. But Iowa deliberately diverges from the aspect of the federal system that provides a counterbalance to that disparity—namely, the credit for foreign taxes.

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[2] This example is somewhat simplified, in part because it does not reflect any change in the apportionment formula as a result of the inclusion of foreign dividends. In Iowa, this change is quite small because Iowa, which uses a single-factor sales apportionment formula, does not include foreign sales in the denominator even when it taxes foreign-source dividends. The only adjustment that it makes is to allow the taxpayer to include in the denominator the amount of the foreign *dividends*, a much smaller number than sales. *See* Iowa Admin. Code r. 701-54.2(2). On the facts of the example, assuming that net income is 5% of sales, the Iowa adjustment to the apportionment formula would reduce the Iowa tax burden on the parent from $4,320 to $4,154, as compared to $2,400 for the parent with a domestic subsidiary.

The example also does not account for the deduction Iowa allows for 50% of the federal tax paid. *See* Iowa Code § 422.34. Because Iowa allows no analogous deduction for foreign tax paid, accounting for this complication would serve only to increase the relative disadvantage suffered by the company with foreign-source dividend income.

The Iowa court is correct in stating that there is no general prohibition against a state's adopting some, but not all, of the features of the federal system. But the Constitution does prohibit Iowa from implementing a system, either on its own or through selective adoption of the federal system, that discriminates against foreign commerce. That is precisely what Iowa has done here.

By adopting the federal intercorporate dividend deduction, Iowa has taken steps to protect corporate taxpayers with domestic subsidiaries from cumulative taxation at both corporate levels. It recognizes that a domestic subsidiary is taxed directly on its earnings, and therefore Iowa refrains from taxing those earnings a second time as income to the parent after they are distributed as dividends. Conversely, in the case of foreign-source dividends, Iowa deliberately embraces this kind of cumulative multi-level taxation. A foreign subsidiary is also taxed directly on its earnings, albeit by a foreign government, but the state ignores that fact. Without providing any credit for the foreign tax paid, Iowa proceeds to tax those earnings a second time as income to the parent after they are distributed as dividends. That approach deliberately and unfairly disadvantages companies that operate foreign subsidiaries as compared to otherwise indistinguishable companies that operate domestic subsidiaries. That sort of discrimination is barred by the Foreign Commerce Clause.

CONCLUSION

The judgment of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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